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No. 10,164

IN THE

United States Circuit Court of Appeals

For the Ninth Circuit

GALLATIN FARMERS COMPANY
(a corporation),
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Upon Petition to Review a Decision of the United States Board of Tax Appeals.

BRIEF FOR PETITIONER.

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BRIEF FOR PETITIONER.

STATEMENT OF JURISDICTION.

On April 2, 1941, the Commissioner of Internal Revenue mailed by registered mail, to Gallatin Farmers Company, petitioner on review, a notice of deficiency, determining a deficiency of income tax for the years ended December 31, 1938 and December 31, 1939, in the sum of $512.44. (T. 3.) In accordance with the provisions of Section 272 (a) (1) I. R. C. the petitioner on review filed on June 9, 1941, a petition with the United States Board of Tax Appeals for a redetermination of the aforesaid deficiency. (T. 1.) On January 28, 1942, decision of the United States Board

of Tax Appeals was duly entered sustaining the determination of the Commissioner of Internal Revenue. (T. 32.) In accordance with the provisions of Section 1141, I. R. C., the petitioner on review on April 20, 1942, filed with the United States Board of Tax Appeals a Petition for Review to the United States Circuit Court of Appeals for the Ninth Circuit seeking to have said Circuit Court of Appeals review the decision of the said Board entered on January 28, 1942. (T. 32, 36.) The return of the tax in question was made to the Collector for the District of Montana. (T. 3; 13.)

STATEMENT OF THE CASE.

Gallatin Farmers Company, the petitioner on review, is a corporation, incorporated and operating under the provisions of chapter 38 of the Civil Code of the State of Montana. (T. 14, 15.) The corporation is a farmers' cooperative. It kept its accounts and filed its tax returns on the accrual basis. There was issued and outstanding during the years in question, so-called preferred stock in the principal sum of $13,300.00, the holders of which were paid $798.00 in each of said years, said sums being claimed by petitioner on review as interest paid, and as such were deducted from gross income. (T. 15.) This deduction the Commissioner disallowed. (T. 8.)

In the year ended December 31, 1939, petitioner accrued patronage dividends in the sum of $14,860.30 which sum was paid subsequent to the close of the

taxable year. (T. 16.) The Commissioner disallowed as deductions a portion of the aforesaid accrual of patronage dividends upon the theory that the petitioner must first, out of current year's earnings provide for dividends on common stock, dividends on preferred stock, provision for reserve fund, and provision for educational fund, and the remainder, if any, to be available for patronage dividends. (T. 16.)

The 6% dividend on common stock for the calendar year 1939 was declared and paid out of prior years' earnings. (T. 16.)

The net income of petitioner for the calendar year 1939, after deduction of the 6% dividend on the preferred stock was $14,031.72. (T. 16.)

The case was submitted upon an agreed stipulation of facts. (T. 14, 22.)

The two questions presented to the United States Circuit Court of Appeals are

(a) Is the payment of $798.00 for each of the years 1938 and 1939 a payment of interest on a debt or the payment of a dividend on capital stock?

(b) May a cooperative in Montana organized and operating under the provisions of Chapter 38 of the Civil Code of Montana pay out all of its earnings as patronage dividends, or is it mandatory under the law that the payment of dividends on common stock and additions to the reserve fund and educational fund be first provided for from current year's earnings?

SPECIFICATION OF ERRORS.

The petitioner on review adopted as its statement of point to be relied on, the assignments of error appearing in the petition for review. (T. 39.)

These are as follows:

1. The error of the United States Board of Tax Appeals in failing to allow the petitioner on review to deduct as interest the sum of $798.00 during each of the years 1938 and 1939, paid on the debt represented by preferred stock.

2. The error of the United States Board of Tax Appeals in refusing to allow the petitioner to deduct from gross income the sum of $14,860.30 accrued as patronage dividends payable for the year ended December 31, 1939.

ARGUMENT.

The important question involved in this case is the question of the amount the cooperative may declare as patronage dividends. There is no question here as to the amount which was accrued. In paragraph VII of the stipulation of facts, appearing at page 16 of the Transcript of the Record the following appears:

> "That there was accrued on the books of the petitioner as patronage dividends at the end of the calendar year 1939 the sum of $14,860.30 which sum was paid subsequent to the close of the taxable year 1939."

The net income for 1939, before any dividends or additions to reserve or educational funds, was $14,-829.72. (T. 16.)

The deficiency here asserted was arrived at by holding that the petitioner must first, out of current earnings, pay the dividend on common stock $1183.20, the dividend (or interest) on preferred stock $798.00, a provision for reserve fund $642.43 and a provision for educational fund $610.30. (T. 16.) (T. 11.)

The petitioner, however, paid its dividend on common stock out of a prior year's earnings (T. 16) and did not set aside any amount as an addition to reserve or as an educational fund. (T. 17.)

The Board of Tax Appeals in its opinion relies on *Cooperative Oil Ass'n, Inc. v. Commissioner of Internal Revenue,* 115 Fed. (2d) 666, but petitioner feels that that case is not at all to be construed in the way the Board has done. The question in the case here on appeal is as to whether the Law of the State of Montana required the allocation of income contended for by the Commissioner or whether that allocation was permissive. Nothing was stated by the Board as to this question.

It has been held for so long a period that patronage dividends are a proper deduction from gross income, that it is not considered necessary to burden the brief with citations as to that point.

There is also no dispute here involving the question of whether the patronage dividends were a liability or not. It is stipulated that they were accrued and paid.

The sole question is the construction of the Montana Statute and that has not been touched on by the Board of Tax Appeals.

The pertinent section of Chapter 38 of the Civil Code of Montana (Section 6387 Revised Codes of Montana, 1935) is as follows:

> "The directors of a co-operative association, subject to revision by the stockholders at a general or special meeting, may apportion the earnings of the association by first paying dividends on the paid up capital stock, not exceeding six per cent. (6%) per annum on the par value thereof, from the remaining funds, if any, accessible for dividend purposes, not less than five per cent. (5%) of the net profits for a reserve fund until an amount has accumulated in said reserve fund amounting to thirty per cent. (30%) of the paid up capital stock, and from the balance, if any, five per cent. (5%) for educational fund to be used for teaching cooperation, and the remaining of said profits, if any, by uniform dividends upon the amount of purchases of patrons, and upon the wages and for salaries of employees, the amount of such uniform dividends on the amount of their purchases, which may be credited to the account of such patrons on account of capital stock of the association; but in production associations such as creameries, canneries, elevators, factories, and the like, dividends shall be on raw material delivered instead of on goods purchased. In case the association is both a selling and a productive concern, the dividends may be on both raw material delivered, and on goods purchased by patrons."

The Commissioner, in asserting his deficiency, has interpreted the foregoing provision of the Montana law to be mandatory. If this section is to be construed as mandatory, then the Court must place other than the plain meaning on the words used. The statute says the Directors *may* do certain things, unless a different policy is adopted by the stockholders, at a general or special meeting. The statute is a guide, and a limitation on the directors. They *may* declare 6% on common stock, they *may* add to the reserve fund until 30% of the capital stock is reached and they *may* provide for an educational fund. If the Court were to assume that the legislators did not know the use of words, the Commissioner's construction might be followed, but this view cannot be justified as in the same section the legislature says "* * * in production association, * * * dividends *shall* be on raw material delivered."

The Montana Supreme Court has only had one occasion to touch upon this question. In that opinion it was said in the special concurring opinion by Chief Justice Johnson:

> "Except for limited authorized application to dividends on capital stock and the establishment of a reserve fund and an educational fund, any and all excess of receipts over the usual operating outlays is mandatorily required paid."
>
> *Gallatin Farmers Co. v. Shannon, et al.*, 109 Mont. 155, 93 Pac. (2d) 953.

There again the permissive and the required are segregated. The Chief Justice states that except for

authorized dividends and additions to reserves, all excess of receipts over the usual operating outlays, is *mandatorily* required paid (as patronage dividends).

The argument here must be directed to the Commissioner's determination as the opinion and decision of the Board is silent on the question involved, other than to sustain the Commissioner. It would seem the Board is asking for statutory authority for the deduction of patronage dividends, where none exists (T. 31) and overlooks the fact that patronage dividends are but a rebate or discount on purchases, and as such have uniformly been held to be a deduction from gross income. *Fruit Growers Supply Co. v. Commissioner,* 21 B. T. A. 315, 326, affirmed 56 Fed. (2d) 90, 10 A. F. T. R. 1277.

Petitioner contends that there is nothing in the Montana law prohibiting the payment of all the net income as patronage dividends or rebates, and this is just what has been done. Stipulation VII in the stipulation of facts (T. 16) so states.

If we adopt another theory and state, but do not admit, that Montana law is mandatory as to the dividends and reserves contended for by the Commissioner, the fact remains that petitioner *did* pay out all of its net profit in 1939 as patronage dividends, therefore it could have no taxable income for such year, unless the Court should hold that $798.00 paid to so-called preferred stockholders, was a dividend and not interest.

The other point relied upon in this appeal is the question of the legal effect of the preferred stock. The

wording on the certificate itself (T. 21, 22) and the amendment of the charter to authorize the issue (T. 19) would indicate that this was an issue of preferred stock and nothing else. If such alone were the case, petitioner would concede that the payment of the $798.00 to preferred shareholders, was a dividend. However, a certificate of stock constitutes a contract between the corporation and the shareholder. As in any other contract, the parties themselves are entitled to place their own construction on it. The motion adopting the resolution creating the preferred stock, according to the minutes of the stockholders' meeting read as follows:

> "Motion was made by John Paugh, seconded by E. J. S. Moore, and unanimously carried that the resolution be adopted as read, it being understood and explained that the preferred stock would be a debt of the Corporation, the dividend to be in the form of interest payable annually regardless of earnings, and that the Board of Directors could issue the said preferred stock as they deemed necessary, and redeem it as the finances of the Corporation permitted."
>
> (Transcript of the Record 19, 20.)

The question on the intent of the parties has been covered by our Courts, in the following words:

> "If it be shown that dividends paid are, according to the intent of the parties, in fact interest, and the stock on which the dividends are paid is merely held by the creditor as security, it makes no difference what the reason was for paying in that form. The courts look to the real character

> of the payment, and construe the statute liberally in favor of the taxpayer."
>
> *Commissioner of Internal Revenue v. Proctor Shop,* 82 F. (2d) 792.

The Montana statute by law takes away part of the usual character of preferred stock in this class of corporation.

> "The holders of preferred stock shall have no voting power and shall not participate in the management and affairs of the association * * *"
>
> Sec. 6381, *Revised Codes of Montana,* 1935.

In another case the Court has gone beyond the face of the transaction to determine the true facts.

> "We therefore conclude that a taxpayer who borrows money at a usurious rate of interest and who, to conceal the usury, is compelled to execute a document which does not correctly describe the relationship of the parties, may, as against the government, disclose the true relationship of debtor and creditor. Sums paid by it as interest regardless of the name by which it is called, may be deducted by the taxpayer from its income."
>
> *Arthur R. Jones Syndicate v. Commissioner,* 23 F. (2d) 833.

We return for a moment to the decision of the Board of Tax Appeals, using as authority *Cooperative Oil Association, Inc. v. Commissioner.* In that case the question was not the same. There, a portion of the earnings were placed in a reserve and were not set aside subject to the demand of the patrons. In this

case it is stipulated that the amount in question was accrued and subsequently paid. (T. 16.) The issue here is whether, in the face of Montana law, the petitioner could declare the amount it did. The Commissioner of Internal Revenue in that case set out the practice in his brief, which is quoted by the Court as follows:

> "The situation is fully set forth by the following quotation from respondent's brief which is unchallenged by petitioner: 'There is no express statutory provision permitting the deduction of so-called patronage dividends by corporations subject to taxation. The administrative practice, however, has been to permit cooperative associations, even though not exempt from taxation, to deduct from gross income the amount returned to their patrons, whether members or non-members, upon the basis of the purchases or sales, or both, made by or for them. This is upon the theory that a cooperative association is organized for the purpose of furnishing its patrons goods at cost or for obtaining the highest market price for the produce furnished by them.' "
>
> *Cooperative Oil Ass'n, Inc. v. Commissioner of Internal Revenue,* 115 F. (2d) 666.

It is submitted, that this Court must hold that the Board of Tax Appeals erred as complained of by the Petitioner on Review and;

1. That the relation of debtor and creditor exists between the Gallatin Farmers Company and its holders of preferred stock and that the payments to said preferred shareholders consti-

tute interest paid and as such are deductible from gross income; and

2. That the Gallatin Farmers Company did in fact accrue and pay $14,860.30 as patronage dividends or rebates for the calendar year 1939 and by such action, had no taxable net income for the said year.

Dated, San Francisco,
August 31, 1942.

Respectfully submitted,
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